

# A response to the The PRA's CP16/22

## Chapter 9

### Output floor

#### Introduction

UK Finance is the collective voice for the banking and finance industry. Representing more than 250 firms, we act to enhance competitiveness, support customers, and facilitate innovation.

We are pleased to respond to chapter 9 of the PRA's [CP 16/22](#) on implementing Basel 3.1 in the UK, which sets out its proposals to implement the Basel 3.1 standards for the output floor with respect to firms' calculation of own funds requirements.

#### The need for the output floor

Our members have never believed that an output floor, which limits the capital benefit a bank can obtain from its use of internal models, relative to using the standardised approaches, is necessary. Where regulators have concerns about the risk sensitivity of firms' own internal credit risk models, we believe that they should instead seek to improve the architecture for model approval to address their concerns and promote consistency. Such an approach has already been introduced via the EBA's roadmap of IRB reforms, in which the PRA and UK firms have participated. UK specific initiatives such as the move to the hybrid approach to firms' internal risk weighting of mortgage exposures have similarly addressed the PRA's concerns about PD modelling in this loan class.

However, we realise that the concept of the output floor is firmly embedded in the Basel framework and unlikely to be removed in the medium term.

**Question 49: Do you support the scope and levels of application of the PRA's proposed output floor? Do you have any additional evidence on the potential impact of these proposals with respect to different activities or particular business lines?**

### *Level of application of the output floor*

#### *Recommendation 9.1*

- Consideration should be given to applying the output floor at the highest level of consolidation only

#### *Rationale*

Many of our members believe the output floor should be applied only at the highest level of consolidation within the UK, rather than at sub-consolidated ring-fenced bank level. Application at this level might mitigate potentially disproportionate effects on specific balance sheets, such as the fragmented UK balance sheets post-ring fencing and post-Brexit. However other members, particularly building societies who believe that ring fencing has negatively impacted their ability to compete in the UK mortgage market, do not share this view.

Given that these differing views are driven by the treatment of mortgages under the standardised approach, it is important that the issues set out in our response to questions 13 and 14 are considered carefully. We understand the PRA's desire to achieve convergence in relation to mortgage risk weights, but an approach that simply increases mortgage risk weights for IRB banks will directly result in detriment to UK consumers. Instead, a more appropriate way to achieve convergence that is reflective of the risk profile of mortgages and avoids the likely consumer detriment, would be to lower the risk weights for low LTV mortgages (<55% LTV) under the standardised approach. If this issue and the treatment of unrated corporates are resolved, then the level of application of the output floor for UK domiciled groups and ring-fenced banks may become moot.

### **Disapplication of output floor to overseas banks operating in the UK**

#### *Recommendation 9.2.*

- The PRA should take into account any temporary or permanent sub-equivalent application of the output floor in its decision to apply it to 3<sup>rd</sup> country banks.

#### *Rationale*

Some of our members believe that UK domiciled banking groups will be at a competitive disadvantage compared to overseas banks operating in the UK, directly because of the proposal not to apply a UK output floor to such firms.

In upholding the principle of applying the floor at the highest level of consolidation in the UK, some of our members believe it is important that the UK subsidiaries and branches of third country banking groups only benefit from the concession in the UK where the third country banking groups are subject to an equivalent output floor.

We support the PRA's deference to the home state regulator. Some of our members suggest it should also be conscious of any permanent or temporary sub-equivalence during the implementation phase, such as those proposed by the EU in relation to mortgages and unrated corporates. Such proposals create a benefit for EU firms and place UK domiciled groups at a competitive disadvantage when operating in the UK and we note that the PRA proposes to monitor this.

### **Responsibility for equivalence determinations**

#### *Recommendation 9.3*

- HMT should take responsibility for making third-country equivalence determinations in relation to the floor.

#### *Rationale*

Instead of having ad hoc data collection exercises on the impact of the output floor as proposed in the consultation paper to ascertain the impact to such subsidiaries using internal models, we propose that, unless the competitive issues are resolved, HM Treasury is given the responsibility to make equivalence decisions in relation to the floor. This mirrors its existing responsibilities where assessment of third country equivalence in other areas of financial services legislation is required. The PRA should provide information or advice to the HM Treasury in connection with such an equivalence determination, as is already the case. Such equivalence decisions should not only focus on the end-state implementation of the output floor; instead, they should also reflect any areas of temporary sub-equivalence during the implementation phase, such as those proposed by the EU in relation to mortgages and unrated corporates. In many of our members' views such proposals represent a significant benefit for EU and US firms that would place UK domiciled groups at a competitive disadvantage when operating in the UK.

**Question 50: Do you have any comments on the PRA's proposal that when the output floor is activated, 'floored' RWAs should be used wherever relevant in all elements of the capital stack? Do you have any additional evidence that is relevant to this proposal to inform the PRA's analysis?**

### **PRA Buffer implications**

#### *Recommendation 9.4*

- For PRA buffer calculation purposes, the impact of the transitional impact of the output floor should be excluded.

### Rationale

As we note in our response to Chapter 10 – Pillar 2, during the transitional period of the output floor there is a likelihood that there will be an increase in the PRA buffer within the ICAAP, with no concomitant increase in risk, merely the by stepping up of the output floor transitional multiplier.

As the output floor increase from 50-72.5% it will build an element of regulatory strain into the calculations alongside the economic/market stress. This number will be then applied to the increased output floor in future years.

Simplistically the below calculation assumes decreases in lending offset increases in capital requirements during the stress, so these remain flat pre-application of the output floor. Starting RWAs are assumed to be 1,000 (80 CRR) for both IRB and 50% application of output floor.

PRA Buffer (pre floor)	Y0	Y1	Y2	Y3
<i>Movement in Capital requirements</i>	-	-	-	-
<i>Movement in Capital Resources</i>	-	-10	-20	-25
<i>Difference (PRA Buffer)</i>	-			25

The above calculations would provide a PRA buffer of 2.5%. The below workings with Y0 being in 2025 and the 50% capital floor raising to 65% capital floor in Y3. The capital requirements would increase from 1000 in Y0 to 1,300 in Y3 an increase in 24 of CRR.

PRA Buffer (post floor)	Y0	Y1	Y2	Y3
<i>Movement in Capital requirements</i>	-	8	16	24
<i>Movement in Capital Resources</i>	-	-10	-20	-25
<i>Difference (PRA Buffer)</i>	-			49

In this example the PRA buffer increases from 2.5% to 4.9% only because of the impact of the output floor introduction. This increased PRA buffer would then be applied to the increased output floor calculation in future years. This would be particularly more penal on mid-tier firms who often go for extended periods without a full assessment of the PRA buffer by the PRA.

### Proposal

We propose that for PRA buffer calculation purposes the impact of the transitional impact of the output floor should be excluded. This could be achieved by applying the end state throughout to calculation of the buffer. Of course, our member firms will continue to ensure they hold sufficient capital resources independently of the PRA buffer calculation.

## **Stress testing**

### *Recommendation 9.5*

- The contribution of the output floor to declines in CET1 as a result of stress testing should be excluded.

### *Rationale*

The introduction of the output floor may significantly contribute to the forecast decline in the excess above the hurdle rate/capital requirements in stress tests; this decline in surplus CET1 capital is a key factor in the calibration of the PRA buffer. As a result, if left unadjusted, the quantum of PRA buffer assigned to a firm may include the effects of a one-off regulatory policy change, and not simply the potential impact of stress over a forward-looking time horizon.

If not re-calibrated, the PRA buffer applicable to a firm could include the effect of the output floor policy change, resulting in an unnecessary buffer increase based on requirements that no longer feature in a firm's forward-looking capital planning horizon.

This problem could be overcome by excluding the contribution of the output floor to the stress test decline in surplus CET1 capital above the BoE hurdle / capital requirements when calibrating the PRA buffer.

The impact of Basel 3.1 changes, in particular the output floor, on the calculation and application of the Pillar 2 will be complex and needs to be considered as part of the review of the Pillar 2 framework in 2024.

## **Excess Expected Losses deduction/Surplus Provision**

### *Recommendation 9.6*

- An RWA equivalent of the excess EL deduction should be added back to the total risk weighted assets for the purpose of making output floor comparisons.

### *Rationale*

There is no consideration given for IRB firms that are constrained by the output floor that also incur a capital deduction for Excess Expected Loss (EEL - i.e. where IRB expected losses > IRB Provisions). This will not only impact firms under a BaU scenario but also through the stress and impact on PRA buffer.

Firms captured by the new capital floor will already have seen an increase in their capital requirements and then also require additional capital resource because of any EEL deduction. Under the IRB approach for credit risk, RWAs cover unexpected loss with a separate calculation of expected loss (with a CET1 capital deduction for any EEL. The

Standardised Approach covers both expected and unexpected loss so a firm constrained by the output floor would be double counting an element of Expected Loss. This would also apply to any surplus provision added back to Tier 2 capital (i.e. where IRB expected losses < IRB provisions) An element of provisions are being double counted as they will have been deducted in arriving at the Exposure At Default (EAD) on a Standardised basis under the output floor but an element also added back to Tier 2 capital (subject to a cap of 0.6% of IRB RWAs). See below for a high level example of EEL and surplus provision.

The example below covering the 0.6% provision add back point.

	Total RWAs (IRB basis)	Total EL (IRB Basis)	Total ECLs / Provisions	EEL deduction / (surplus provision)	CET 1 deduction / (Surplus provision add back capped at 0.6% of IRB RWAs)	Total RWAs STA (basis)	Output Floor limit (72.5%)	Comment
Scenario 1 – EEL deduction	£40bn	£0.2bn	(£0.1bn)	£0.1bn	£0.1bn	£60bn	£43.5bn	Increase in RWA covering expected and unexpected losses with addition deduction for EEL i.e. double count of an element of Expected Losses
Scenario 2 – Surplus provision	£40bn	£0.2bn	(£0.5bn)	(£0.3bn)	(£0.24bn)	£60bn	£43.5bn	ECLs/ Provisions utilised in STA RWA calculation and also added back at Tier 2 level i.e. double count of an element of provisions.

These impacts would be further exacerbated under stress scenarios where increases in EL deductions will feed into the PRA buffer calculation which will then be applied to the output floor which again appears overly penal.

To ensure that the comparison for the purposes of the floor is done on an equitable basis, we recommend to adopt an approach that allows the excess EL deducted from CET1 to be added to the IRB RWAs for the purposes of the floor calculation. We also consider that it is necessary to take into account any excess provisions that are included in Tier 2 within the calculation.

In Canada, OSFI has taken the approach that an RWA equivalent of the excess EL deduction is added back to the total risk weighted assets for comparing with the output floor (or in the case of a surplus provision, an RWA equivalent of the surplus provision is deducted from total risk weighted assets). The difference (i.e. the output floor impact) is added to the total risk weight assets. We ask that apply a similar approach. (See link to section 1.5 of the OSFI rule text)

[https://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/CAR22\\_index.aspx](https://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/CAR22_index.aspx)

**Question 51: Do you have any comments on the PRA's proposed transitional arrangements including the proposal to not apply the discretionary transitional cap?**

We note that the PRA is not proposing to apply the transitional cap to limit the incremental increase in RWAs as a result of application of the output floor at 25% for the duration of the transition period. Our members have no comment on this aspect of the PRA's proposed implementation of the output floor.

**Output floor and securitisation transactions***Recommendation 9.7*

- The PRA should engage with industry on the impact of the output floor on significant risk transfer transactions and a transitional measure introduced to adjust the p-factor during the UK's review of the Securitisation Regulation.

*Rationale*

IRB firms that are originators of securitisation and significant risk transfer transactions generally calculate capital on the retained portion of these securitisations using SEC-IRBA - a modelled approach.

But for output floor purposes RWAs must be calculated using SEC-SA, on a non-modelled standardised basis.

Whilst it is welcome that firms will not have to recalculate the commensurate risk transfer test, the SEC-SA risk weights on the retained tranches are generally significantly higher than when using SEC-IRBA.

The introduction of the output floor introduces uncertainty as there is a possibility that future balance sheet changes could effectively switch the binding calculation for an SRT from SEC-IRBA to SEC-SA over the life of a deal, even if we were not bound by the output floor at the start of the transaction.

The PRA has acknowledged that the impact that the output floor may have on SRT transactions. It is important that the PRA engages soon with the industry on this issue, not just during the transitional period as firms are currently in the process of designing and executing transactions that will mature during and after the transitional period for the floor.

Furthermore, until a final policy position on the application of the floor to securitisation, it is important that a transitional provision be put in place. We understand that the European Parliament (EP) has a proposed such a transitional measure which would adjust the p-factor for SEC-SA to 0.5 for non-Simple, Transparent and Standardised (STS) securitisation and to

0.25 for STS securitisation for all bank roles i.e. originator, investor and sponsor, until the completion of the comprehensive review of the EU's securitisation framework. In conjunction with this, it is important the risk weight floor is decreased from 10% to 7% for STS securitisation and from 15% to 12% for non-STS securitisation. We would recommend the PRA adopt a similar transitional approach until the completion of HMT's review of securitisation. To do otherwise risks putting the UK at a competitive disadvantage

#### *Other issues*

##### *Inconsistent approaches to LTV calculation*

We note that the SA requires origination valuation to be applied for LTV calculation purposes, whereas IRB which allows indexation. This difference will extend the impact of the output floor differential. We believe a consistent valuation approach - indexation - should be used by IRB firms to calculate the output floor.

#### *Responsible executives*

✉ [simon.hills@ukfinance.org.uk](mailto:simon.hills@ukfinance.org.uk)  
☎ +44 (0) 7921 498183

✉ [nala.worsfold@ukfinance.org.uk](mailto:nala.worsfold@ukfinance.org.uk)  
☎ +44 (0) 7384 212633